Pillar III Disclosures 2014

The Paragon Group of Companies PLC

paragon

Contents

CAUTIONARY STATEMENT

Sections of this document may contain forward-looking statements with respect to certain of the plans and current goals and expectations relating to the future financial condition, business performance and results of The Paragon Group of Companies PLC ('the Group'). These have been made by the directors in good faith using information available up to the date on which they approved this document. By their nature, all forward-looking statements involve risk and uncertainty because they relate to future events and circumstances that are beyond the control of the Group and depend upon circumstances that may or may not occur in the future. There are a number of factors that could cause actual future financial conditions, business performance, results or developments to differ materially from the plans, goals and expectations expressed or implied by these forward-looking statements and forecasts. Nothing in this document should be construed as a profit forecast.

1. Background

The Group

The Paragon Group of Companies PLC ('the Company') controls a group of companies ('the Group') which form three principal trading business operations:

- Paragon Mortgages, which includes most of its originated loan assets;
- Idem Capital, its loan portfolio investment and third party servicing business; and
- Paragon Bank, the Group's banking subsidiary, which operates through Paragon Bank PLC and accepts savings deposits from customers and invests them in buy-to-let mortgage and consumer loans.

Each division is responsible for the generation of new business with servicing and the majority of other support functions managed on a group-wide basis. These divisions form the segments used by the Group to describe its business in its public reporting.

On 18 February 2014 Paragon Bank PLC ('the Bank') was authorised by the Prudential Regulation Authority ('PRA') and is regulated by the PRA and the Financial Conduct Authority ('FCA'). The PRA sets requirements for the Bank relating to capital and liquidity adequacy.

The Group's other divisions are subject to various forms of conduct regulation, principally by the FCA, but are not subject to PRA regulation. The Group as a whole is the subject of consolidated supervision by the PRA by reason of the Company being the parent company of the Bank. The PRA sets requirements for the consolidated group in respect of capital adequacy, but not in respect of liquidity.

Disclosure framework

A legislative capital adequacy framework, the Capital Requirements Directive (CRD - also known as Basel II) was introduced in the European Union in 2007 which governs the amount of capital that banks and building societies are required to hold in order to protect their members, depositors and shareholders. The aim of Basel II is to make regulatory capital requirements more risk sensitive and representative of risk management controls and procedures in place within firms. The Group seeks to ensure that it protects stakeholders by holding sufficient capital at all times.

The Basel III regulatory framework was finalised in December 2010 by the Basel Committee on Banking Supervision and is being implemented in Europe through the Capital Requirements Directive IV ('CRD IV').

The CRD IV text was formally published in the Official Journal of the EU in June 2013 and became effective from 1 January 2014. It is made up of the Capital Requirements Regulation ('CRR'), which is directly applicable to firms across the EU, together with the Capital Requirements Directive ('CRD'), which must be implemented through national law. CRD IV also makes changes to rules on corporate governance including remuneration and introduces standardised EU regulatory reporting, referred to as COREP and FINREP.

The PRA, as prudential regulator of the Company, is the body responsible for implementing the CRD in the UK. The Company has been operating under the Basel III regime since the authorisation of its banking subsidiary, Paragon Bank PLC ('the Bank') in February 2014. It has adopted the Standardised Approach for the assessment of credit risk and the Basic Indicator Approach for operational risk.

The CRD consists of three elements, or ‘Pillars’, which represent the key principles of the Basel III regime:

Pillar I

This covers the minimum capital requirements of Basel III. The calculation is based on a risk based approach. It focuses on credit, operational and market risk in determining the Group’s Minimum Capital Requirement (‘MCR’).

Pillar II

This requires that the Group conducts an Internal Capital Adequacy Assessment Process (‘ICAAP’) which is subject to review by the PRA under the Supervisory Review and Evaluation Process (‘SREP’).

In the ICAAP process the Company’s Board undertakes an assessment of the key risks facing the Company’s business against which capital has not been provided under Pillar I to determine whether additional regulatory capital should be held, based on the identified risks and the risk management processes in place. A firm’s Individual Capital Guidance (‘ICG’) is set by the PRA based on the ICAAP.

Pillar III

Pillar III complements Pillars I and II and aims to encourage market discipline by setting out disclosure requirements which should allow market participants to assess key pieces of information on a firm’s capital, risk exposures, risk management processes and remuneration.

Pillar III disclosure policy

This Pillar III disclosure, the first to be made by the Group, covers the Group as a whole, comprising the Company and its subsidiary undertakings. It is therefore prepared on the same basis as the Group’s consolidated accounts for the year ended 30 September 2014 (the ‘Group Accounts’). These bodies are regulated on a consolidated basis and this disclosure treats them as such. References to the Group in this document therefore include Paragon Bank PLC.

The Company’s Disclosure Policy for its Pillar III disclosures is based on its Board of Directors’ interpretation of the requirements of CRD IV. The Pillar III disclosures will be updated on an annual basis using the Group’s year end date of 30 September, following publication of the Annual Report and Accounts. The annual reporting process will include consideration of regulatory changes and developing best practice, to ensure that disclosures remain appropriate. More frequent disclosures will be made if there is a material change in the nature of the Group’s risk profile during any particular year.

Pillar III regulatory capital disclosures are published on the Group’s corporate website www.paragon-group.co.uk.

The Group’s Pillar III regulatory capital disclosure policies were approved by the Board of Directors in February 2015.

The Group Accounts set out a summary of the Group’s risks, together with the controls and procedures in place to mitigate those risks. The latest Group Accounts are also published on the Group’s corporate website.

Basis of disclosure

The figures in this Pillar III disclosure are consistent with the Group Accounts but do not form part of the Group Accounts. The disclosures presented have been reviewed internally but have not been externally audited.

The Pillar III disclosures have been prepared for the Group as a whole, in accordance with the rules laid out in the Articles 431 to 451 of Part 8 of the CRR. The disclosures provide information on the capital adequacy and risk management processes of the Group. These disclosures have been compiled on the most appropriate basis for this purpose and, as such, may not agree directly to similar measures presented in the Group Accounts.

The results of all subsidiary undertakings have been included in the Pillar III disclosures. The Bank's requirement to maintain regulatory capital and liquid resources above a level determined by the PRA could restrict its ability to make dividend payments or make loan repayments to other Group entities. There are no other current or foreseen material practical or legal impediments to the prompt transfer of capital resources or repayments of liabilities between the Company and its subsidiary undertakings.

The Bank is required to prepare Remuneration Code Pillar III disclosures. These disclosures are the subject of a separate, stand-alone document and are published on the Bank's website, www.paragonbank.co.uk, on an annual basis.

Approval

The first ICAAP for the Group was prepared as at 30 September 2012 as part of its application for a banking licence for the Bank. It was prepared under the direction of the Finance Director of the Bank and the executive committee of the Group, with appropriate input and challenge from other areas of the business. The ICAAP was reviewed, challenged and approved by the Group's executive and was formally approved by the Board in June 2013. Throughout the ICAAP's preparation, the Board and the prospective independent non-executive directors of the Bank were kept up-to-date with its progress and key findings, as well as receiving regulatory training sessions to ensure that they were able to provide the appropriate level of challenge.

The Group will review the ICAAP on at least an annual basis. The update process will occur more frequently if there is a significant change in the business model (potentially following an acquisition) or the economic environment within which the Group operates.

The Group's regulator carried out a review of the ICAAP as part of its authorisation procedures for the Bank, the conclusion of which was that the actual level of the Group's capital is significantly in excess of the minimum requirements. A SREP of the updated ICAAP is expected to be carried out in the near future.

The Pillar III disclosures were approved for publication by The Paragon Group of Companies PLC in February 2015.

2. Governance

The Group

Good corporate governance is essential to the ethos of the Group. The Board is responsible for overall Group strategy and for the delivery of that strategy within a strong corporate governance and corporate responsibility framework.

In April 2014, a review was undertaken of the Group's Governance and Risk Management Framework (excluding the recently established Paragon Bank) for a number of reasons including to take account of changes in best practice; the need for enhanced management of regulatory and conduct risks to ensure positive outcomes for customers; the Group's increased exposure to regulatory authorities including, but not limited to, the need for a number of entities within the Group to apply for FCA authorisation during 2015 in relation to their consumer credit activities; and the evolving expectations of external stakeholders. The outcome of this review, in so far as it related to the Company's governance structure, is detailed in this section.

Paragon Bank's governance and risk management framework was established as part of its start-up processes and reflects a similar governance structure to that of the Company. This structure is discussed in more detail below.

The Board of Directors is committed to the principles of corporate governance contained in the UK Corporate Governance Code ('Code') issued by the Financial Reporting Council ('FRC') in September 2012 and which is publicly available on their website at www.frc.org. Throughout the year ended 30 September 2014 the Company complied with the provisions of the Code.

The FRC introduced a revised Code for financial years commencing on or after 1 October 2014 and consequently the Group will be reporting against the new Code for the financial year ending 30 September 2015. Work is under way to ensure that the Company complies with the revised Code.

Leadership

The Board of Directors is responsible for overall Group strategy, for approving major agreements, transactions and other financing matters and for monitoring the progress of the Group against budget. All directors receive sufficient relevant information on financial, business and corporate issues prior to meetings and there is a formal schedule of matters reserved for decision by the Board, which includes material asset acquisitions and disposals, granting and varying authority levels of the Chairman and the executive directors, determination and approval of the Group's objectives, strategy and annual budget, investment decisions, corporate governance policies and financial and dividend policies.

During the year ended 30 September 2014 the Board of Directors comprised the Chairman, the executive directors (four for the first eight months of the year and three for the remaining four months) and four independent non-executive directors. A further non-executive director was appointed after the year end. All directors bring a broad and valuable range of experience to the Company.

The division of responsibilities between the Chairman and Chief Executive is clearly established, set out in writing and agreed by the Board. There is a strong non-executive representation on the Board, including Edward Tilly, the Senior Independent Director. This provides effective balance and challenge.

The Board also operates through a number of committees covering certain specific matters, these being:

Board Committees

- The Remuneration Committee, which during the year consisted of Alan Fletcher (who chairs the Committee), Fiona Clutterbuck, Peter Hartill and Edward Tilly, all of whom were independent non-executive directors, and the Chairman of the Company, Robert Dench.
- The Audit Committee (formerly the Audit and Compliance Committee), which during the year consisted of Peter Hartill (who chairs the Committee), Fiona Clutterbuck, Alan Fletcher and Edward Tilly, all of whom were independent non-executive directors. The Board is satisfied that all members of the Committee have recent and relevant financial experience. The Committee meets at least three times a year and is responsible for monitoring internal controls and accounting policies and issues. It supervises the Group's Internal Audit function.

- The Risk and Compliance Committee, which was established during the year and consisted of Fiona Clutterbuck (who chairs the Committee), Peter Hartill, Alan Fletcher and Edward Tilly, all of whom were independent non-executive directors and the Chairman of the Company, Robert Dench. The Committee first met in June 2014 and will meet at least four times a year. It is responsible for the Group's risk management framework and supervises the work of the Group's Risk and Compliance functions. It also receives and considers reports from the Asset and Liability, Credit and Operational Risk and Compliance Committees.
- The Nomination Committee, which during the year consisted of Robert Dench, who chairs the Committee, Nigel Terrington and all of the non-executive directors, ensuring that a majority of the Committee's members are independent non-executive directors.

Hugo Tudor was appointed as an additional non-executive director after the year end and also became a member of each of the above committees.

Executive Committees

- The Asset and Liability Committee ('ALCO') - consisting of the heads of relevant functions and chaired by the Chief Executive during the year. The Group Finance Director became chairman of the Committee after the year end. The Committee meets regularly and monitors Group liquidity risks, interest rate risks, currency risks and treasury counterparty exposures.
- The Credit Committee - consisting of the heads of relevant functions and chaired by the Group Finance Director. It meets regularly and is responsible for establishing credit policy and monitoring compliance therewith.
- The Operational Risk and Compliance Committee - consisting of the heads of relevant functions and chaired by the Chief Operating Officer. This Committee was established following the review of the Group's governance and risk management framework and first met in October 2014. It will meet regularly and is responsible for operational, conduct and business risks.

All board committees operate within defined terms of reference and sufficient resources are made available to them to undertake their duties.

Paragon Bank

The Bank operates within delegated authority from the Board of Directors of the Company but has its own internal governance structure, including a Board with independent outside directors. This is modelled on the provisions of the Code in so far as they can be adapted to apply to a subsidiary entity.

Leadership

The Board of the Bank is responsible for the Bank's overall strategy, for approving major agreements, transactions and other financing matters and for monitoring the progress of the Bank against budget. All directors receive sufficient relevant information on financial, business and corporate issues prior to meetings and there is a formal schedule of matters reserved for decision by the Bank Board, which includes material asset acquisitions and disposals, granting and varying authority levels of the Chairman and the executive directors, determination and approval of the Bank's objectives, strategy and annual budget, investment decisions, corporate governance policies and financial and dividend policies.

During the year, the Bank's Board of Directors comprised the Chairman, two executive directors (the Bank's Managing Director and Finance Director), one independent non-executive director and one non-executive director appointed by the shareholder. A further non-executive director was appointed after the year end. All directors bring a broad and valuable range of experience to the Bank.

All independent directors are appointed for fixed terms. They are kept fully informed of all relevant operational and strategic issues and bring a strongly independent and experienced judgement to bear on these issues. The non-executive directors meet with the Chairman, from time to time, without the presence of the executive directors.

The composition of the Bank's Board and its committees is kept under review, with the aim of ensuring that there is an appropriate balance of power and authority between executive and non-executive directors and that the directors collectively possess the skills and experience necessary to direct the Bank's business activities.

The division of responsibilities between the Chairman and Managing Director is clearly established, set out in writing and agreed by the Bank's Board. There is a strong non-executive representation on the Board which provides effective balance and challenge.

The Bank's Board also operates through a number of committees covering certain specific matters, these being:

Board Committees

- The Remuneration Committee, which during the year consisted of Nigel Terrington (who chairs the Committee), Stephen Blaney and Patrick Newberry.
- The Audit Committee, which during the year consisted of Patrick Newberry (who chairs the Committee), Nigel Terrington and Stephen Blaney. The Board is satisfied that all members of the Committee have recent and relevant financial experience. The Committee meets at least four times a year. This committee is responsible for monitoring internal controls and accounting policies and issues within the Bank and supervises that part of the work of the Group's Internal Audit function relating to the Bank's activities.
- The Risk and Compliance Committee, which during the year consisted of Stephen Blaney (who chaired the committee on an interim basis during the year), Nigel Terrington and Patrick Newberry. Finlay Williamson, a new independent non-executive director, was appointed to chair the Committee after his appointment to the Board. The Committee meets at least four times a year. It is responsible for the Bank's risk management framework and supervises the work of the Bank's Risk and Compliance functions. It also receives and considers reports from the Asset and Liability, Credit and Operational Risk and Compliance Committees.

Finlay Williamson was appointed as an additional independent non-executive director after the year end and also become a member of each of the above committees.

Executive Committees

- The Asset and Liability Committee - consisting of the heads of relevant functions and chaired by the Bank's Finance Director. The Committee meets regularly and monitors the Bank's liquidity risks, interest rate risks, currency risks and treasury counterparty exposures.
- The Credit Committee - consisting of the heads of relevant functions and chaired by the Bank's Managing Director. It meets regularly and is responsible for establishing credit policy and monitoring compliance therewith.
- The Operational Risk and Compliance Committee - consisting of the heads of relevant functions and chaired by the Bank's Chief Risk Officer. It meets regularly and is responsible for operational, conduct and business risks.

Each of the Bank's Committees is also subject to oversight from the corresponding Group Committee.

3. Risk management objectives and policies

The Group regards the effective identification, monitoring and control of risk as an integral part of its management processes. To support this, the Group's risk management framework and supporting risk committee structures have been further developed during the last year.

There are a number of potential risks and uncertainties which could have a material impact on the Group's performance and could cause actual results to differ materially from previous or expected results. To identify and control these risks, the Group utilises a risk management framework which analyses its risks under the categories of Business Risk, Credit Risk, Liquidity Risk, Market Risk, Operational Risk, Conduct Risk and Pension Obligation Risk.

The Group's system of risk management includes the Credit Committee, Operational Risk Committee and ALCO, an experienced Group Risk function and an appropriately qualified internal audit function. This risk management framework is monitored by Board level committees, the Audit and Compliance Committee before June 2014 and the Risk and Compliance Committee thereafter.

The Group's risk management framework operates within a 'Three Lines of Defence' model:

- The first line of defence, comprising the executive directors, their managers and people, holds primary responsibility for designing, operating and monitoring risk management and control processes.
- The second line of defence is provided by the Group Risk and Compliance Committee and supporting sub-committees together with oversight provided by the Group Risk, Credit Risk, Compliance and Financial Crime functions.
- The third line of defence is provided by Group Internal Audit and the Group Audit Committee which are responsible for reviewing the effectiveness of the first and second lines of defence.

The principal risks inherent in the Group's business model include the following:

Business risk

Business risk is defined as any risk to the Group arising from changes in its business, including the risk that the business may not be able to implement its business plan and desired strategy.

The Group's operations are domiciled entirely in the United Kingdom and therefore there is a risk that any deterioration in the general economy might adversely affect the Group's business.

Demand for the Group's buy-to-let products is influenced by the performance of the UK's private rented sector, which in turn is dependent upon underlying factors such as house prices, supply of rental property, demographic changes and government housing policy. Demand for all of the Group's loan products is dependent upon such factors as market interest rates, employment levels and other factors that determine disposable income.

Adverse economic conditions might increase the number of customers that default on their loans or adversely affect funding structures, which may in turn increase the Group's costs and could result in losses on some of the Group's assets, or restrict the ability of the Group to develop in the future.

As part of an established governance process, the Group's executive management undertakes a review of strategic objectives each year. This helps to inform the development of detailed business plans for each of the Group's principal trading operations within which account is taken of key risks and mitigants.

The Group closely monitors economic developments in the UK and overseas, with support from a leading independent macro-economic research company. This ensures it is able to consider various economic scenarios within its formal business planning cycle.

The UK financial services market is highly competitive and the Group faces strong competition in all of the core markets in which it operates, including its lending markets and the debt purchase and asset servicing markets. There is a danger that the Group's profitability and / or market share may be impaired if its offerings do not remain competitive.

To mitigate this risk the Group maintains relationships with its customers, business introducers and other significant participants in the markets in which it is active, as well as being active in industry-wide organisations and initiatives. This enables market trends and their attendant risks to be identified and addressed within the relevant business strategy.

Credit risk

Credit risk is the risk that a loan customer or treasury counterparty will be unable to meet their obligations as they fall due. As a primary lender, the Group faces credit risk as an inherent component of its lending and asset purchase activities. Adverse changes in the credit quality of the Group's loan customers arising from their personal circumstances or from systemic risks in UK and global financial systems could reduce the recoverability and value of the Group's assets.

In order to mitigate credit risk, the Group has comprehensive policies in place that set out detailed criteria which must be met before loans are approved and funds released. These policies are approved by the Credit Committee under authority granted by the Board Risk and Compliance Committee. Credit policies incorporate limits for concentration risk arising from factors such as large exposures to particular counterparties, geographical areas or types of lending. Exceptions to these policies require approval by the Group's Credit Risk function, operating under a mandate from the Credit Committee. The Credit Risk function provides regular reports to the Credit Committee and Risk and Compliance Committee on the performance of the Group's lending.

Originated assets are subject to individual underwriting approval with robust control and support provided by well-established decision tools, while purchased assets are subject to extensive pre-contract due diligence and rigorous ongoing analysis and monitoring.

The Group has a number of approved treasury counterparties. In order to be approved, counterparties must meet specific credit rating criteria. Exposure to these counterparties is monitored daily by senior management within the Group's Treasury function and is reported monthly to the Asset and Liability Committee, a subsidiary committee of the Board's Risk and Compliance Committee.

The Group's approach to the management of credit risk and the systems in place to mitigate that risk on both originated and purchased assets are further described in sections 5 and 6 below.

Liquidity risk

Liquidity risk is the risk that the Group, although solvent, has insufficient financial resources to enable it to meet its obligations as they fall due or finance its future plans, or can only secure such resources at excessive cost.

The Group relies on its access to sources of funding to finance the origination of new business, portfolio acquisitions and working capital. If access to funding became restricted, either through market movements or regulatory or governmental action, this might result in the scaling back or cessation of some business lines.

The Group's banking business relies on retail deposits; therefore changes in market liquidity could impact the ability of the business to maintain the level of liquidity required to sustain normal business activity. In addition, there is a risk that the Group could face sudden, unexpected and large cash outflows from customer withdrawals.

The Group, through ALCO, seeks to mitigate this risk by investigating alternative sources of finance which are, or might become, available to the Group and by keeping its funding and working capital position under review. Paragon Bank is required, under regulation, to hold prescribed levels of liquid funds in order that requests for retail withdrawals can be met.

The Group's capital position and its policies in respect of capital management are described more fully in section 4 below.

Market risk

Market risk is the risk of either a loss of capital or a reduction in earnings arising from an adverse movement in market prices or rates.

Changes in interest rates may adversely affect the Group's net income and profitability. In particular, the Group's profitability is determined by the difference between the rates at which it lends and those at which it can borrow. Therefore any changes in market interest rates which result in a mismatch can impact the Group's profit.

The steps taken by the Group to mitigate against the long term effects of interest rate movements, through the structuring of its products and the use of hedging procedures, are described in section 7 below.

Conduct risk

Conduct risk is the risk that decisions, behaviours, culture and approach lead to poor outcomes for customers.

The Group provides a range of financial services products across several brands to consumers and small business customers. As a result, the Group is exposed to potential conduct risk should it fail to treat its customers fairly. This could arise, for example, if certain products fail to meet the needs of customers or customer complaints are handled ineffectively.

The manner in which financial services companies treat their customers is subject to considerable regulatory scrutiny. There is, therefore, a risk that regulatory bodies may determine that the Group is not ensuring that its customers receive fair treatment. Systemic poor customer treatment may lead to regulatory censure, reputational damage and resulting reductions in the Group's profitability.

As a result, the Group undertakes various mitigating actions in those areas of its business where the potential for this risk is greatest. These actions include the assessment of risks and controls by business owners, separate oversight and assurance, ongoing training for employees and the escalation of material risks and issues to appropriate Group risk committees.

Further information regarding the Group's approach to treating its customers fairly is given in section A5.3 of the Group Accounts.

Operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. It includes reputational risks associated with business practices or market conduct and the risk of failing to comply with applicable laws regulations or policies. It also includes failure to comply with relevant regulatory requirements and/or identify and assess the impact of future regulations.

The Group continues to develop its operational risk management framework. These developments include self-assessments across the Group's business areas to identify significant risks and key controls, the completion of risk registers, the enhancement of risk event reporting and the refinement of risk appetite statements. The risk management process is now overseen by a new Operational Risk and Compliance Committee established in October 2014 which reports to the Board Risk and Compliance Committee.

The activities of the Group subject it to operational risks relating to its ability to implement and maintain effective systems to process the high volume of transactions with customers. A significant breakdown of the IT systems of the Group might adversely impact the ability of the Group to operate its business effectively.

To address these risks, the Group's Operational Risk and Compliance Committee is responsible for reviewing key risk indicators and key controls to ensure that they remain adequate for their purpose. The Group has a business continuity plan, accredited under the International Standard ISO 22301, which is kept under regular review and is designed to ensure that any breakdown in systems would not cause significant disruption to the business.

The customers and market sectors to which the Group supplies products and the capital markets from which it obtains much of its funding, have been subject to legislative and other intervention by UK Government, European Union and other regulatory bodies. Certain of the Group's own activities are also subject to direct regulation. These levels of intervention have increased over recent years and this trend is expected to continue in the future. To the extent that such actions disadvantage the Group, when compared to other market participants, or serve to depress levels of market activity or returns, they present a risk to the Group.

To mitigate this risk, the Group has been active in explaining its position to the authorities so that it is not inadvertently disadvantaged. In order to ensure compliance with the various regulatory regimes it is, or may become, subject to, the Group maintains a Compliance function, as part of its risk management framework, which reviews procedures, examines compliance with them and evaluates knowledge levels across relevant functions. The Group also ensures that all employees receive appropriate regulatory training.

The Group recognises that its success is dependent upon recruiting and retaining skilled senior management and personnel at all levels of the organisation. The levels of regulation surrounding business conduct mean that a highly trained operational workforce is vital to the Group's ability to conduct business. Failure to maintain the necessary skill base would put at risk the Group's ability to successfully carry out its plans.

The Group's employment policies, which are designed to mitigate this exposure and ensure that an appropriately skilled workforce is, and remains, in place are described within section A5.1 of the Group Accounts.

Pension obligation risk

Pension obligation risk is the risk of contractual or other liabilities in respect of the Group's pension arrangements leading to costs which would reduce its scope to undertake other business activities.

The Group operates a defined benefit pension plan ('the Plan'), which is closed to new entrants. Its commitments under this plan expose it to the risk that the assets of the scheme may be insufficient to meet its liabilities, either due to the investment performance of the Plan or the present assumptions of future inflation and members' salaries or mortality rates being inaccurate.

In conjunction with the Trustee, the Group conducts asset-liability reviews of the Plan. These studies are used to assist the Trustee and the Group to determine the optimal long-term asset allocation with regard to the structure of liabilities within the Plan. The results of the studies are used to assist the Trustee in managing the volatility in the underlying investment performance and risk of a significant increase in the scheme deficit by providing information used to determine the investment strategy of the Plan.

The Group's exposure to risks relating to its pension arrangements is discussed in more detail in note 53 to the Group Accounts.

Other risks

The Group's exposure to other financial risks, including certain liquidity risks and market risks not described above, together with the procedures in place to mitigate those risks are described in detail in note 7 to the Group Accounts.

4. Capital resources

The Group is subject to supervision by the PRA on a consolidated basis, as a group containing an authorised bank. As part of this supervision the regulator will issue individual capital guidance setting an amount of regulatory capital, defined under the international Basel III rules, implemented through the Capital Requirements Regulation and Directive ('CRD IV'), which the Group is required to hold relative to its risk weighted assets in order to safeguard depositors against the risk of losses being incurred by the Group.

The Group's regulatory capital is monitored by the Board of Directors and ALCO, who ensure that appropriate action is taken to ensure compliance with the regulator's requirements. The future regulatory capital requirement is also considered as part of the Group's forecasting and strategic planning process.

Both the Group and the Bank's capital risk appetite are linked to their wider risk appetite statement and ultimately their strategy.

The overriding objectives of the Group's capital risk appetite are to:

- maintain capital quantity and quality to cover current and future risks within the Group;
- maintain sufficient capital to be able to survive a range of severe but plausible stressed scenarios; and
- utilise capital in order to generate a strong return for shareholders.

The Group's approach to defining capital risk appetite takes into account its prudent approach to operations and strong control environment. The risk appetite is described in both quantitative and qualitative terms:

- quantitatively, by describing the overall risk limits numerically. These limits cover the quantity and quality of capital to be held; and
- qualitatively, by outlining core principals in managing or mitigating risk and ensuring that the Group and the Bank have the necessary capabilities to prudently manage capital risks, and provide management with sufficient information to effectively oversee operations and risk levels.

At 30 September 2014 the Group's regulatory capital of £981.1m was comfortably in excess of that required by the regulator. Throughout the period from authorisation to that date, the Group's regulatory capital also complied with these requirements.

The Group's regulatory capital differs from its equity as certain adjustments are required by the regulator. A reconciliation of the Group's equity to its regulatory capital determined in accordance with CRD IV at 30 September 2014 is set out below.

		2014 £m
Total equity		947.1
Deductions		
Proposed final dividend		(18.3)
Intangible assets		(7.9)
Deferred tax adjustment	*	(0.5)
Common Equity Tier 1 ('CET1') capital		920.4
Other tier 1 capital		-
Total Tier 1 capital		920.4
Corporate bond		110.0
Less: amortisation adjustment	†	(53.8)
		56.2
Collectively assessed credit impairment allowances		4.5
Total Tier 2 capital		60.7
Total regulatory capital		981.1

* Deferred tax assets in subsidiary companies are required to be deducted from regulatory capital. This balance is offset against the deferred tax liability in the consolidated accounts.

† When tier 2 capital instruments have less than five years to maturity the amount eligible as regulatory capital reduces by 20% per annum. As the Group's £110m Corporate Bond matures in 2017, this adjustment is required.

The risk weighted assets calculated under the CRD IV framework against which this capital is held and the proportion of these assets it represents, are calculated as shown below.

	2014 £m
Credit risk	
Balance sheet assets	4,220.8
Other	108.7
Total credit risk	4,329.5
Operational risk	337.1
Market risk	-
Total risk weighted assets	4,666.6
	%
Solvency ratios	
CET1	19.7
Total regulatory capital	21.0

The CRD IV risk weightings for credit risk exposures are calculated using the Standardised Approach.

The table below shows the calculation of the leverage ratio, based on the consolidated balance sheet assets, adjusted for amounts already provided in the Group Accounts and the post offer pipelines of loan assets at 30 September 2014.

	2014 £m
Total balance sheet assets	10,895.1
Post offer pipeline	207.7
Exposure	11,102.8
Tier 1 capital	920.4
Leverage ratio	8.3%

The regulatory capital disclosures above relate only to the consolidated position for the Group. Individual entities within the Group are also subject to supervision on a standalone basis. All such entities complied with the requirements to which they were subject during the year.

5. Credit risk

The Group's business objectives rely on maintaining a high-quality customer base and place strong emphasis on good credit management, both at the time of acquiring or underwriting a new loan, where strict lending criteria are applied, and in the collections process.

Primary responsibility for credit risk management across the Group lies with the Credit Committee. The Credit Committee is made up of six senior employees, headed by the Group Finance Director. Its key responsibilities include setting and reviewing credit policy, controlling applicant quality, tracking account performance against targets, agreeing product criteria and lending guidelines and monitoring performance and trends.

In order to control credit risk relating to counterparties to the Group's derivative financial instruments, short-term investments and cash deposits, ALCO determines which counterparties the Group will deal with, establishes limits for each counterparty and monitors compliance with those limits.

The carrying values of the assets of the Group which are subject to credit risk are set out below:

	2014 £m
Loans to customers	9,255.9
Investments in structured entities	19.3
Derivative financial assets	693.9
Accrued interest	0.3
Short term investments	39.4
Cash	848.8
Maximum exposure to credit risk	**10,857.6**

While this maximum exposure represents the potential loss which might have to be accounted for by the Group, the terms on which the Group's loan assets are funded limit the amount of principal repayments on the Group's securitised and warehouse borrowings in cases of capital losses on assets, significantly reducing the effective shareholder value at risk.

The Group's risk weighted assets, used in determining its Pillar I capital requirement can be analysed by category as shown below.

	Exposure £m	Risk weighted exposure £m	Minimum capital required £m
Government and central banks	39.4	-	-
Credit institutions	1,543.2	459.0	36.7
Total liquidity exposures	1,582.6	459.0	36.7
Non-residential and business lending	418.6	417.7	33.4
Residential lending – performing	8,781.0	3,154.2	252.3
Residential lending – non-performing	62.2	62.3	5.0
Loans and advances to customers before impairment	9,261.8	3,634.2	290.7
Fixed and other assets	53.4	53.4	4.3
Total on balance sheet exposures	10,897.8	4,146.6	331.7
Off balance sheet exposures - pipeline	207.7	74.2	5.9
Total credit risk exposure	11,105.5	4,220.8	337.6

These calculations use the Standardised Approach for credit risk for all asset classes and the Basic Indicator Approach for operational risk. A risk weighting of 8% is applied to risk weighted asset values calculated in accordance with Article 92 of the CCR to determine the minimum Pillar I requirement for credit risk.

The Group has a very low operational risk appetite, highlighted by its lack of historic operational risk losses. In order to assess whether a Pillar IIa add-on is required for operational risk, the Group has reviewed historic operational losses, as well as performing scenario analysis on the Group's major operational risks.

Loans to customers and other investments in loan assets

The Group's credit risk is primarily attributable to its loans to customers. There are no significant concentrations of credit risk due to the large number of customers included in the portfolios.

The Group's loan assets at 30 September 2014 are analysed as follows:

	2014 Gross loan assets £m	2014 Impairment provisions £m	2014 Net loan assets £m	2014 %
Buy-to-let mortgages	8,670.6	78.5	8,592.1	92.8%
Owner occupied mortgages	68.1	8.5	59.6	0.7%
Total first mortgages	8,738.7	87.0	8,651.7	93.5%
Secured loans	442.8	6.6	436.2	4.7%
Loans secured on property	9,181.5	93.6	9,087.9	98.2%
Car loans	6.5	0.8	5.7	0.1%
Retail finance loans	2.3	1.9	0.4	-
Other loans	180.4	18.5	161.9	1.7%
Total loans to customers	9,370.7	114.8	9,255.9	100.0%

First mortgages and secured loans are secured by charges over residential properties in England and Wales, or similar Scottish or Northern Irish securities. Car loans are effectively secured by the financed vehicle.

Other loans include unsecured loans either advanced by Group companies or acquired from their originators at a discount.

All of the loans shown allow the customer to repay the balance early and this facility is often used, especially for mortgage loans. It is therefore considered that an analysis of these balances by contractual maturity would not provide useful information.

The Group's underwriting philosophy is based on a combination of sophisticated individual credit assessment and the automated efficiencies of a scored decision making process. Information on each applicant is combined with data taken from a credit reference bureau to provide a complete credit picture of the applicant and the borrowing requested. Key information is validated through a combination of documentation and statistical data which collectively provides evidence of the applicant's ability and willingness to pay the amount contracted under the loan agreement.

Despite the existence of the security described above, in assessing credit risk, an applicant's ability and propensity to repay the loan remain the principal factors in the decision to lend.

In considering whether to acquire pools of loan assets or invest in loan portfolios, the Group will undertake a due diligence exercise on the underlying loan accounts. Such assets are generally not fully performing and are offered at a discount to their current balance. The Group's procedures may include inspection of original loan documents, verification of security and the examination of the credit status of loan customers. Current and historic cash flow data will also be examined. The objective of the exercise is to establish, to a level of confidence similar to that provided by the underwriting process, that the assets will generate sufficient cash flows to recover the Group's investment and generate an appropriate return.

An analysis of the indexed loan to value ratio ('LTV') for those loan accounts secured on property by value at 30 September 2014 is set out below. For acquired accounts the effect of any discount on purchase is allowed for.

	2014 First Mortages %	2014 Secured Loans %
Loan to value ratio		
Less than 70%	48.5	28.7
70% to 80%	25.9	14.5
80% to 90%	16.4	18.1
90% to 100%	5.7	15.8
Over 100%	3.5	22.9
	100.0	100.0
Average loan to value ratio	71.4	
Buy-to-let	71.7	
Owner-occupied	32.4	

The regionally indexed LTVs shown above are affected by changes in house prices, with the Nationwide house price index, for the UK as a whole, registering an annual increase of 9.4% in the year ended 30 September 2014. The increase in average prices, however, is part of a more volatile picture, which has been particularly marked at the local and regional level. The Group maintains a specialist team of in-house surveyors to maximise its understanding of particular markets, both from a valuation and lettings standpoint.

The Group conducts valuations of properties given as security at the inception of loans and updates the valuations from time to time as part of its arrears management process, typically conducting drive-by or full valuations as accounts move through arrears states. LTV amounts shown above are based on the most recent valuation of each property on the Group's records.

In determining appropriate allowances for impairment the most recent valuation of the security will be used, with a discount reflecting the potential impact of a forced sale.

An analysis of those loan accounts secured on property, classified by property location, by value at 30 September 2014 is set out below. For acquired accounts the effect of any discount on purchase is allowed for.

	2014 £m
Region	
Greater London	1,490.5
South East	2,466.9
South West	943.1
East Anglia	318.6
East Midlands	507.7
West Midlands	443.0
North	363.1
North West	1,005.7
Yorkshire and Humberside	1,028.1
Total England	8,566.7
Northern Ireland	24.6
Scotland	177.2
Wales	344.5
Total United Kingdom	9,113.0

The £9,113.0m of loans shown above are disclosed as £8,627.0m of first mortgages and £441.0m of secured loans in the aged analysis presented in the Group Accounts.

The number of accounts in arrears by asset class, based on the most commonly quoted definition of arrears for the type of asset, at 30 September 2014, compared to the industry averages at those dates published by the Council of Mortgage Lenders ('CML') and the Finance and Leasing Association ('FLA'), was:

	2014 %
First mortgages	
Accounts more than three months in arrears	
Buy-to-let accounts including receiver of rent cases	0.25
Buy-to-let accounts excluding receiver of rent cases	0.04
Owner-occupied accounts	3.94
CML data for mortgage accounts more than three months in arrears	
Buy-to-let accounts including receiver of rent cases	0.78
Buy-to-let accounts excluding receiver of rent cases	0.69
Owner-occupied accounts	1.55
All mortgages	1.42
Secured loans	
Accounts more than 2 months in arrears	19.84
FLA data for secured loans	17.20
Car loans	
Accounts more than 2 months in arrears	7.85
FLA data for all personal loans	4.10
Other loans	
Accounts more than 2 months in arrears	87.50

No published industry data for asset classes comparable to the Group's other books has been identified.

The Group calculates its headline arrears measure for buy-to-let mortgages, shown above, based on the numbers of accounts three months or more in arrears, including purchased Idem Capital assets, but excluding those cases in possession and receiver of rent cases designated for sale. This is consistent with the methodology used by the CML in compiling its statistics for the buy-to-let mortgage market as a whole.

The number of accounts in arrears will be higher for closed books such as the owner-occupied mortgage book and the retail finance and unsecured loan books than for comparable active ones, as performing accounts pay off their balances, leaving arrears accounts representing a greater proportion of the total.

The figures shown above for secured loans and other loans include purchased portfolios which generally include a high proportion of cases in arrears at the time of purchase and where this level of performance is allowed for in the discount to current balance represented by the purchase price.

An analysis of the Group's loan assets between assets held within securitisation structures, those within warehouse structures awaiting securitisation, those held within Paragon Bank and other loan assets is shown below.

	First Mortgages £m	Consumer Finance £m	Total £m
Loans funded by			
Securitisation structures	7,094.7	528.5	7,623.2
Warehouse facilities	1,526.4	-	1,526.4
	8,621.1	528.5	9,149.6
Paragon Bank assets	0.5	5.3	5.8
Other loans to customers	30.1	70.4	100.5
	8,651.7	604.2	9,255.9

At 30 September 2014 98.9% of the carrying value of the Group's loans to customers was funded by securitisations and structures affecting the credit risk exposure of the Group in a similar way (see Section 8).

The payment status of the carrying balances of the Group's loan assets, before provision for impairment, at 30 September 2014 split between those accounts considered as performing and those included in the population for impairment testing, is shown below.

First Mortgages

	2014 £m
Not past due	8,477.6
Arrears less than 3 months	125.0
Performing accounts	8,602.6
Arrears 3 to 6 months	5.9
Arrears 6 to 12 months	3.9
Arrears over 12 months	20.2
Possessions and similar cases	39.4
Impairment population	69.4
	8,672.0

Consumer Finance

	Secured loans £m	Car loans £m	Retail Finance loans £m	Total £m
30 September 2014				
Not past due	291.2	3.8	0.1	295.1
Arrears less than 2 months	33.8	2.0	-	35.8
Performing accounts	325.0	5.8	0.1	330.9
Arrears 2 to 6 months	24.5	0.1	-	24.6
Arrears 6 to 9 months	12.4	-	-	12.4
Arrears 9 to 12 months	11.9	-	0.1	12.0
Arrears over 12 months	67.2	0.6	2.0	69.8
Impairment population	116.0	0.7	2.1	118.8
	441.0	6.5	2.2	449.7

Other Loans

	2014 £m
Not past due	14.5
Arrears less than 1 month	1.0
Performing accounts	15.5
Arrears 1 to 3 months	1.1
Arrears 3 to 6 months	1.5
Arrears 6 to 12 months	4.0
Arrears over 12 months	157.9
Impairment population	164.5
	180.0

Arrears in the tables above are based on the contractual payment status of the customers concerned. Where assets have been purchased by the Idem Capital loan investment business, customers may already have been in arrears at the time of acquisition and an appropriate adjustment made to the consideration paid.

Under the CRD, mortgages are past due if repayments are 90 days or more in arrears at the accounting date. The Group closely monitors arrears of loan repayments and impairment provisions are made where appropriate. The Group's accounting policy for impairments of loan assets is set out in note 3 to the Group Accounts and full details of movements in impairment provisions are set out in note 33 to the Group Accounts.

For capital adequacy purposes, collectively assessed credit impairment allowences are considered to be Tier 2 capital.

Investments in structured entities represent the Group's contribution made to special purpose vehicle ('SPV') companies established and controlled by third parties to purchase pools of loan assets. All such investments are denominated in sterling and the underlying loans are made to United Kingdom borrowers. Cash generated by the assets is distributed to investors in accordance with a specified priority of payments. The Group has no obligation to make further contributions to the SPV companies concerned.

Management has considered the position of the underlying assets and concluded that they will generate sufficient cash flows to repay the amount of the investment.

In the debt purchase industry, Estimated Remaining Collections ('ERC') is commonly used as a measure of the value of a portfolio. This is defined as the sum of the undiscounted cash flows expected to be received over a specified future period. In the Group's view, this measure may be suitable for heavily discounted, unsecured, distressed portfolios, but is less applicable for the types of portfolio in which the Group has invested, where cash flows are higher on acquisition, loans may be secured on property and customers may not be in default. In such cases, the IAS 39 amortised cost balance, at which these assets are carried in the Group balance sheet, provides a better indication of value.

However, to aid comparability, the 84 and 120 month ERC values for the Group's purchased assets included in the Idem Capital division are set out below, analysed by the balance sheet line on which they appear. These are derived using the same models and assumptions used in the EIR calculations, but the differing bases of calculation lead to different outcomes.

	2014 Carrying value £m	2014 84 month ERC £m	2014 120 month ERC £m
Loans to customers	407.2	554.8	649.9
Investments in structured entities	19.3	26.6	32.3
	426.5	581.4	682.2

Amounts shown as loans to customers above include loans disclosed as first mortgages and other loans.

6. Counterparty credit risk

The Group's Treasury Policy statements include policies covering liquidity risk, interest risk and foreign exchange risk and a Counterparty Policy, which are used to manage the credit risk that arises from exposures to treasury counterparties. The Counterparty Policy limits the Group's exposure to individual counterparties, and compliance with the policy is reviewed monthly by ALCO.

Derivative financial assets

In order to control credit risk relating to counterparties to the Group's derivative financial instruments and cash deposits, ALCO determines which counterparties the Group will deal with, establishes limits for each counterparty and monitors compliance with those limits. Such counterparties are typically highly rated banks and, for all cash deposits and derivative positions held within the Group's securitisation structures, must comply with criteria set out in the financing arrangements, which are monitored externally. Where a derivative counterparty fails to meet the required criteria they are obliged under the terms of the instruments to set aside a cash collateral deposit. The amounts of these cash collateral deposits, which do not form part of the Group's cash position, are shown below.

The Group's exposure to credit risk in respect of the counterparties to its derivative financial assets, analysed by their long term credit rating as determined by Fitch is set out below.

	2014 £m
Carrying value of derivative financial assets	
Counterparties rated	
AA-	193.5
A+	4.2
A	496.2
Gross exposure	693.9
Collateral amounts posted	(87.3)
Net exposure	606.6

The values shown above are calculated as the fair value of the assets at the balance sheet date in accordance with the provisions of IFRS 13 – 'Fair Value Measurement'.

None of the financial instruments to which the Group is a party have conditions requiring it to post collateral.

Short term investments

The Group's short term investments are held within the Bank and form part of the liquidity buffer it is required to hold by the PRA. These investments may only be placed in treasury bills and gilts issued by the UK government, or such similar instruments as are permitted by the regulator, and as such the credit risk is judged to be minimal. These assets are shown in the accounts of the Group at their current market value at the balance sheet date.

Cash and cash equivalents

The Group's cash balances are held in sterling at highly rated banks in current accounts and as short fixed term deposits and money market placements. The Group has a large exposures policy to mitigate any concentration risk in respect of its cash deposits. Credit risk on these balances and the interest accrued thereon is considered to be minimal.

7. Interest rate risk

As identified in section 2 of this disclosure document, this is the risk of loss of income from movements in interest rates. Such losses can occur because of the differing characteristics of the various elements within the balance sheet and mismatches between balances with the same characteristics on opposite sides of the balance sheet.

It has been established in the ICAAP that the interest rate risks to which the Group is most exposed, if mitigating action is not taken, are re-pricing and basis risk.

These risks arise where balance sheet components are subject to different market forces. This includes exposures where interest is linked to different reference rates, the impact of fixed rate assets and liabilities and the effect of different classes of assets and liabilities re-pricing at different times.

The Group maintains limits and uses derivative financial instruments in order to keep interest rate risk at a manageable level that is appropriate. ALCO monitors interest rate risk exposure on the Group's loan assets and asset backed loan notes and ensures compliance with the requirements of the trustees in respect of the Group's securitisations.

The Group has performed stress testing in order to assess whether a Pillar IIa add-on is required for interest rate risk and capital has been provided in accordance with the results.

8. Securitisation

One of the Group's principal sources of funding is asset securitisation. The largest part of this funding relates to securitisations issued under the 'Paragon Mortgages' programme but other issues have been made from time to time to support other parts of the business.

The strategy underlying the Group's securitisation activities is to gain access to attractive funding rates for its lending activities and to mitigate liquidity risk by match funding the underlying loan assets. The structures are not intended to achieve significant transfer of credit risk away from the Group. The risk relating to the underlying assets therefore remains with the Group and is included in the credit risk analyses in this document.

A more detailed description of the Group's securitisation activities and how they affect the Group's risk profile and contribute to its risk management objectives is given in note 7 to the Group Accounts.

There are no specific capital requirements for the Group's securitisation vehicle companies. Further information on the Group's securitisations, on a transaction by transaction basis is provided in note 51 to the Group Accounts and detailed information on each of the Group's public securitisation transactions is published in the Bond Investor section of the Group's corporate website at www.paragon-group.co.uk.

The Group has no exposures to purchased securitisation positions.

9. Country-by-country reporting

The Capital Requirements (Country-by-Country Reporting) Regulations 2013 came into effect on 1 January 2014 and place certain reporting obligations on financial institutions that are within the scope of CRD IV.

The objective of the country-by-country reporting requirements is to provide increased transparency regarding the source of the Financial Institution's income and the locations of its operations.

The Paragon Group of Companies PLC is a UK registered entity. Details of its principal subsidiaries are given in note 28 to the Group Accounts and the activities of the Group are described in section A2.1 of the Group Accounts.

The activities of the Group, described as required by the Regulations for the year ended 30 September 2014 were:

	United Kingdom £m
Year ended 30 September 2014	
Total operating income	**197.9**
Profit before tax	**122.8**
Tax on profit	**25.6**
Public subsidies received	**-**
Average number of full time equivalent employees	**924**

10. Remuneration policies and practices

Paragon Bank is required to prepare Remuneration Code Pillar III disclosures in addition to the regulatory capital disclosures. These disclosures are the subject of a separate, stand-alone document and are published on the Paragon Bank website, www.paragonbank.co.uk, on an annual basis.

Information on the remuneration of the directors of the Group is contained in the Directors' Remuneration Report presented as section B3 of the Group Accounts.

Glossary

ALCO	Asset and Liability Committee
Bank	Paragon Bank PLC
CET1	Common Equity Tier 1
CML	Council of Mortgage Lenders
Code	UK Corporate Governance Code
Company	The Paragon Group of Companies PLC
CRD	Capital Requirement Directive
ERC	Estimated Remaining Collections
EU	European Union
FCA	Financial Conduct Authority
FLA	Finance and Leasing Association
FRC	Financial Reporting Council
Group	The Paragon Group of Companies PLC and all its subsidiary entities
Group Accounts	Annual Report and Accounts of The Paragon Group of Companies PLC for the year ended 30 September 2014
IAS	International Accounting Standard
ICAAP	Internal Capital Adequacy Assessment Process
ICG	Individual Capital Guidance
IFRS	International Financial Reporting Standard(s)
ILAA	Internal Liquidity Adequacy Assessment
LTV	Loan to value
MCR	Minimum Capital Requirement
Plan	The defined benefit pension plan operated by the Group
PRA	Prudential Regulation Authority
SREP	Supervisory Review and Evaluation Process

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